No. 20,845

United States Court of Appeals

For the Ninth Circuit

Kent-Reese Enterprises, Inc., Raymond Douglass and Robert Reese,
Appellants,
vs.
Walter Hempy, Trustee of Big Boy Markets, Inc., Bankrupt,
Appellee.

APPELLANTS' OPENING BRIEF

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PERNAU-WALSH PRINTING CO., SAN FRANCISCO

Subject Index

Table of Authorities Cited

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JURISDICTION OF PROCEEDINGS

Sections 1331 and 1334 of Title 28 of the United States Code are the basis for the jurisdiction of the U. S. District Court, Northern District of California, Southern Division, in which this case originated.

This appellate case being an appeal from that Court and relating to the subject matter described below, the United States Court of Appeals for the Ninth Circuit properly has jurisdiction of this appeal under the provisions of Title 28 of the United States Codes, § 1291 and § 1294.

This jurisdiction is supported: (I) By the allegations of the COMPLAINT (Tr. pp. 1-4) which state

(a) That Plaintiff HEMPY's Bankrupt (i.e., BIG BOY MARKETS, INC.) filed a voluntary bankruptcy petition in the U. S. District Court, Northern District of California, Southern Division, on October 19, 1960, and was adjudged to be bankrupt by that Court (Tr. p. 7); (b) That Plaintiff was the Trustee, in said bankruptcy, duly appointed (Tr. p. 2); (c) That said Bankrupt was a California Corporation, and (d) That Plaintiff claimed a fraudulent transfer of property of the alleged value of $41,000 as a violation under Bankruptcy Act sections 67e and 70e (Tr. pp. 1-3; paragraphs I, VIII, XII); and by (II) The admissions of the ANSWER (Tr. pp. 5, 6) which admitted jurisdictional allegations but denied the other matters.

STATEMENT OF THE CASE

As was concisely and comprehensively reviewed and well stated by the Trial Judge in his Findings of Fact (Tr. pp. 7-11) and as Appellants will endeavor to summarize with emphasis on the principal issue, this case involves the legal effect of the guarantee agreement dated November 1, 1959 (Tr. pp. 8a, 9) made by and with the Bankrupt at that time when Bankrupt was solvent and operating two super markets at Santa Rosa, California. In each of these markets, Appellant KENT-REESE ENTERPRISES, INC. (hereinafter called "KENT-REESE") was an independent entity operating, as a tenant, the off-sale liquor business (Tr. p. 2, Findings 5).

Bankrupt then owed Appellants DOUGLASS and REESE $30,700 (Tr. pp. 8a, 9; Findings 6, 7, 8) which money had been deposited by them with the Bankrupt in late 1958 and early 1959 for the purchase of preferred stock of Bankrupt. Bankrupt had been unable to obtain the prerequisite authorization from the State of California to permit issuance of such stock. After depositing this stock-purchase money for that purpose, they had later permitted Bankrupt to use those funds in its business upon a temporary demand-loan basis.

In the latter part of 1959, Bankrupt wanted to continue having the use of this money while it continued to seek authorization for the preferred stock issuance. Appellants DOUGLASS and REESE were unwilling to forego their right to its return *unless* Appellant KENT-REESE would guarantee to them that KENT-REESE would repay that money to them if Bankrupt should fail to pay them. (Tr. pp. 8a, 9; Findings 6, 7, 8.) At that time Appellant KENT-REESE owed Bankrupt a balance exceeding $30,700 on a $54,000 promissory note and it was willing to guarantee such repayment upon condition that Bankrupt would grant KENT-REESE the right to apply against said promissory note balance any sums which it became responsible thereunder to pay to Appellants DOUGLASS and REESE (Tr. pp. 8a, 9; Findings 7, 8).

This three-way arrangement had been orally agreed upon between the parties and thereafter was reduced to writing by the November 1, 1959, written guarantee contract (EXHIBIT 15 at the trial) which is the

principal document involved in these proceedings (Tr. pp. 3-4; Findings 7, 8).

After said agreement, Bankrupt's efforts to obtain authorization for issuance of preferred stock were unsuccessful and the $30,700 continued to be owing to Appellants DOUGLASS and REESE.

About one year after the written guarantee agreement, Bankrupt filed its petition in bankruptcy (Tr. p. 10; Findings 10, 11) and Appellants DOUGLASS and REESE made demand upon Appellant KENT-REESE for their money. They did not file claims in bankruptcy stating that they felt they were secured creditors through the guarantee. Appellant KENT-REESE subsequently paid them for the account of the Bankrupt on the basis of said guarantee and refused to pay the promissory note balance of $31,000 to the Trustee in Bankruptcy. It based its actions upon the guarantee contract and its right to offset against the unpaid promissory note balance the amounts so paid to Appellants DOUGLASS and REESE who received those payments (Tr. pp. 10, 11; Findings 11, 12) and also have refused to deliver this money to the Trustee.

SPECIFICATION OF ERRORS

1. Appellants particularly except to and specify as erroneous the *Conclusions of Law* set forth as Conclusions numbered (2) (starting after its first sentence) and (3), (4), (6), (7) and (9). (Tr. pp. 11-13) and the judgment in its entirety.

The essence of the appeal and of the error specified (as is also set forth in "STATEMENT OF POINTS ON WHICH APPELLANTS INTEND TO RELY ON APPEAL" attached to the transcript which would be pp. 24 and 25, as added) is *that the Nov. 1, 1959, guarantee agreement did,* in fact and in law, *effect a present and effective transfer at that time*—and not a transfer imputed to "immediately prior to filing in bankruptcy," as was concluded by the Trial Judge.

ARGUMENT OF CASE AND LAW

The applicable laws of two fields appear to affect the making of a correct decision on this determinative point and question: Did the November 1, 1959, guarantee agreement effect a transfer of an asset or of an interest in an asset, by the then-solvent Bankrupt on that date?

(1) The first and basic relevant field of law is the California State law, i.e.: Under California law is such a guarantee, or pledge of an account receivable in the possession of the pledgee, operative and effective to transfer to the party guaranteed, or the pledgee, immediately an interest in the subject asset?

The California courts have constantly recognized that a guarantee is, by its very nature, conditioned upon the occurrence of a possible or contingent future event but that the guarantee becomes a recognized and existing contract obligation as of the date of its execution.

As stated in the summary of California law in 46 Cal.Jur.2d at page 244 under the subject "Suretyship and Guaranty", § 35, in which encyclopedia it is earlier discussed that California treats guaranty and surety contracts similarly, it is stated:

> "The liability on a suretyship obligation commences with the giving of the undertaking though it is unenforceable until the principal obligation matures."

Cited on this point particularly are *Lambert v. Haskell* (1889) 80 Cal. 611, 22 Pac. 327 and *First National Bank v. Consolidated Lumber Company* (1911) 16 Cal.App. 267, 116 Pac. 608.

In the *Lambert v. Haskell* case concerning the interpretation of a surety agreement to be effective upon the continuation of a temporary injunction, the Court stated (pp. 617, 618), that ". . . in interpreting the terms of a contract of suretyship the same rules are to be observed as in the case of other contracts", citing Civil Code § 2837 and further stating:

> "One of these rules is that a contract must be interpreted so as to make it operative and capable of being carried into effect, if it can be done without violating the intention of the parties. (Civil Code § 1643.)"

More directly to the point, in *First National Bank v. Consolidated Etc.*, the defendant corporation had sold plaintiff a promissory note and defendant corporation and stockholders too guaranteed its future payment with the words: "For value received, we hereby guarantee the payment of the within note at

maturity . . ." (i.e., about six months after assignment). The defendants pleaded the defense of the three-year limitation of actions. The Court stated (pp. 268, 269):

> "It is quite true that the liability incurred by the Newport Lumber Company was not enforceable until the maturity of the note and default made by the makers thereof. It cannot be said, however, that the liability was not created until such time. Liability does not depend for its existence upon the fact that it is immediately enforceable. It may exist without the right of immediate enforcement. (*White v. Green,* 56 Iowa 176, 74 N.W. 928; *Hunt v. Ward,* 99 Cal. 612, 37 Am.St.Rep. 87, 34 Pac. 335.) In the latter case it is stated, 'A liability may be absolute or contingent; it may be conditional or limited; it may be presently enforceable by action or there may be time given for its performance; of whatever its character, it is created by the consummation of the contract, act, or omission by which the liability is incurred.' Under the terms of the contract, the liability incurred by the Newport Lumber Company was absolute, although the right of the plaintiff to enforce such liability depended upon a contingency, namely: the default of the makers of the note; but this fact did not render the liability contingent. There is a marked distinction between a contingent liability and the right contingent upon the happening of an event to enforce an existing liability. In the one case, there is no liability until the happening of the event, the occurrence of which creates the liability, while in the other a liability exists, but the right to enforce it depends upon the con-

tingency. Here there was an existing indebtedness in a sum specified in the note which the makers promised to pay to the holder thereof. By its contract of guaranty the corporation agreed that it would pay this indebtedness when the note was due, if the makers of the note failed to pay it. It follows, we think, that the liability was created on August 31, 1905, at a time when the corporation by contract obligated itself to make the payment. If this be true, the cause of the action to enforce defendant's statutory liability as a stockholder of the Newport Lumber Company was barred in three years from said date."

This is still the California law on this point, unchanged by the statutory elimination (in 1939) of the difference between guarantee and surety contracts.

(2) The second field is the federal law of the Bankruptcy Act which applies to the extent that it sets up the standards or characteristics for the claimed offense: the fraudulent transfer—which the Trial Court in this case only found to be fraudulent because the transfer was imputed, technically, to have incurred at a fictitious time, "immediately prior to bankruptcy" rather than on or before November 1, 1959.

Granting that under California law the guarantee contract (which in this case was even more enforceable because the Bankrupt's $31,000 promissory account receivable asset was in the possession of the recipient of the Bankrupt's guarantee, KENT-REESE) was immediately operative and effective to

give KENT-REESE the benefit of that guarantee should the condition stated therein later occur, then this guarantee contract was immediately a fully effective "transfer" under the Bankruptcy Act and was not operative and effective at a fictitious, imputed future date.

The express provisions of the Bankruptcy Act defining a "transfer" in the applicable parts thereof (Title 11, Chapter 1 entitled "Definitions," § 1 under the title, "Meaning of Words and Phrases", subsection 30) read:

> "(30) 'Transfer' shall include the sale and every other and different mode, direct or indirect, of . . . *parting with property or with an interest therein . . . or of fixing a lien upon* property or upon *an interest therein,* absolutely *or conditionally,* voluntarily or involuntarily, by or without judicial proceedings, as a conveyance . . ., payment, *pledge,* mortgage, *lien, encumbrance,* gift, *security or otherwise;* the retention of a security title to property delivered to a debtor shall be deemed a transfer suffered by such debtor."

Even if we disregard the California law making a guarantee an immediately-effective contract and creating immediately an obligation against the maker's assets and consider only the express wording and definitions quoted above, it would seem clear that the November 1, 1959, contract (Tr. pp. 8a, 9; Finding 7) effected a "transfer" as that term is used in the Bankruptcy Act.

The written contract of November 1, 1959 (Exhibit 15), expressly and explicitly gave to Appellant

KENT-REESE, and to Appellants DOUGLASS and REESE as the third party beneficiaries of that guarantee, a lien upon the money which Appellant KENT-REESE owed to the Bankrupt. Appellant KENT-REESE, in order to reimburse itself for making good its guarantee to them, had the right to offset against the Bankrupt the amount of its obligations to DOUGLASS and REESE.

By express terms of this agreement, on the date of its execution, the Bankrupt certainly parted with an interest in the KENT-REESE promissory note obligation to the Bankrupt, and fixed a lien upon that asset in the hands of KENT-REESE as the recipient of the Bankrupt's contract and guarantee, even though the lien was subject to future conditions which might or might not occur.

Certainly *this contract* obligation effected *a pledge* and the giving of *a lien,* and *encumbrance* or *security,* to KENT-REESE.

All of these are clearly within the express provisions of the Bankruptcy Act set forth above and recognize as a transfer the giving of rights in or control over the asset of the (later) Bankrupt.

(3) Possibly there arose in the mind of the Trial Judge, or there may arise in the minds of the Justices of the Circuit Court of Appeals questions such as: Doesn't this recognition of such an immediate effect to a guarantee conditioned on a future contingency conflict with the economic realities of business? Or: In view of the fact that the guarantee-activating conditions actually occurred later when the

guarantor was insolvent, isn't the recognition of the effectiveness of the guarantee agreement as of the date of its execution an unrealistic technicality?

The answers to both questions would be "no." The presumption which might make such questions seem equitable or reasonable does not exist. In business and in accounting practices concerning businesses whenever an asset is subjected to any conditions or contingencies which might affect its future liquidity, or availability, etc., *they are immediately recognized as affecting that asset.*

If we look to authorities in the accounting and auditing fields to see whether or not the creation of such a contingent liability is recognized by accountants and auditors as affecting assets and properties immediately upon the creation of the contingent liability, we find that what the Bankruptcy Act recognizes as a "transfer" at the time it is made is also recognized by these authorities as affecting the asset.

In "ACCOUNTING FOR LAWYERS" by E. McGruder Faris, Jr., LL.M., Professor of Law at Wake Forest College, published in 1964, this authority says under the heading "Contingent Liabilities," page 347, and under the sub-title "Presenting Contingent Liabilities by Means of Accounting Entries":

> "The amount of a contingent liability is removed from net worth pending the actual outcome of the contingency."

In the book "BASIC ACCOUNTING PRINCIPLES" by Earl A. Saliers, Ph.D. CPA, Professor

of Accounting at Louisiana State University, co-authored by Arthur W. Holmes, B.S.C., Assistant Professor of Accounting at the University of Cincinnati, under the heading, "Analysis of Financial Statements," page 601, they state:

> "7. Contingent Liabilities.—Contingent liabilities should be shown somewhere in the balance sheet, or indicated by means of foot notes. Perhaps the most common ones are those arising in connection with notes receivable discounted, accounts receivable sold, and accommodation endorsements. Contingent liabilities are an uncertain factor on the balance sheet, but liberal allowance should be made for what may become a direct liability of the business."

One of the leading corporate and tax loan authors, Robert H. Montgomery, CPA, former President of the American Institute of Accountants and former Professor of Accounting at Columbia University, in the sixth edition (1940) of his book, "AUDITING THEORY AND PRACTICE" at page 122 under the title "Accounts Sold or Pledged", says:

> ". . . If the accounts are pledged to secure loans, the amount of the accounts pledged should be stated in the description of the assets . . ."

Further, under the title, "Contingent Liabilities," at page 322, discussing what matters should be reflected by proper accounting, he further writes:

> "As used in auditing procedure, the term 'contingent liabilities' includes (1) primary or direct liabilities which after date of the balance sheet (a) are determinable in amount but do not be-

come enforceable unless some future event occurs . . .

"*Primary Liabilities:* Class (2) includes secondary or indirect liabilities as to which no obligation exists unless and until the primary obligor defaults, such as: (i) . . . (ii) indorsement of notes for affiliated or subsidiary concerns; (iii) accommodation endorsement of accounts receivable or installment obligations when the transfer attaches a contingent liability; (v) . . ."

CONCLUSION

In summary, Appellants DOUGLASS and REESE in late 1958 and early 1959 deposited funds with Appellee's Bankrupt which they were entitled to have returned to them in 1959, upon demand; however, in 1959 at the request of the Bankrupt and solely for the benefit of the Bankrupt at a time when it was solvent, Appellants DOUGLASS and REESE agreed to forego their right to an immediate return of their money but only in consideration of the guarantee arrangements of the guarantee contract which is the subject of this appeal and the key to the correct decision (Tr. pp. 8a, 9; Findings 7, 8).

On the date of that contract, November 1, 1959, Appellant KENT-REESE committed itself to its obligations to DOUGLASS and REESE but it only undertook these obligations to them in consideration of and in reliance upon its contract right, should the conditions set forth in the agreement occur, to offset against the Bankrupt whatever amount the Bankrupt

might have failed to pay on its obligations to DOUGLASS and REESE, offsetting such amounts against the money which it (KENT-REESE) owed to the (then solvent) Bankrupt.

Under California law and under the express definition of a "transfer" by the Bankruptcy Act, this transaction was a legitimate business arrangement for the benefit of the (then solvent) Bankrupt and created contingent security lien rights which were operative and effective as of the date of the signing of that contract.

This transaction was a legitimate and proper business type of transaction to aid the (then solvent) Bankrupt and was accomplished by legal, proper and business-like means. The contract rights created, although contingent, were of a type occurring frequently in business and which accountants and auditors recognize as immediately affecting the assets involved.

To brand this transaction, which was helpful to the Bankrupt as a "fraudulent transfer" imputed to be effective at a later date through an improperly-applied legal fiction is unjust and an improper decision by the Trial Court in that regard.

At a time when Appellee's Bankrupt was solvent and operating two large markets, Appellant KENT-REESE incurred its obligations to DOUGLASS and REESE, which are contract obligations which it must honor and from which it cannot escape by reason of any legal fiction imputing to its side of this three-way contract any fraud or illegality.

Under a proper application of the State law and Bankruptcy Act provisions to the facts of this case, neither could the Bankrupt escape honoring the corollary pledge and contract obligations it made to KENT-REESE by its part in the guarantee contract.

In justice to the other contracting parties, the Appellants, the Bankrupt should be held to honor its contract validly entered into at a time when it was solvent and benefited therefrom.

Dated, Oakland, California,
July 12, 1966.

Respectfully submitted,
C. Wadsworth White,
Attorney for Appellants.

Certificate of Counsel

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

C. Wadsworth White,
Attorney for Appellants.